

# CALIFORNIA BOARD OF ACCOUNTANCY

## *SUNSET REVIEW REPORT*

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of the California Legislature

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## I. INTRODUCTION.

The year 2002 saw the accounting profession propelled into the public's eye in an unprecedented manner due to the Enron audit failure and subsequent other similar matters. It was clear to the California Board of Accountancy that immediate and sustained change was critical, and it was equally evident that California had to take a strong leadership role not only to pursue legislative reform in this state but also to exert influence at the national and federal levels.

In the midst of a global crisis of confidence because of these corporate failures, California's Legislature enacted a series of reforms that have dramatically changed the regulation of the profession. These reforms bring new requirements, new information, new challenges and new mandates to the Board, all generating a substantially increased workload, concurrent with the state government hiring freeze and budgetary constraints. Concomitant with the changes, this Board is undergoing its fourth sunset review since 1996.

Pursuant to sunset review requirements, the California Board of Accountancy reports on the following three subjects:

- Report on Problems with Respect to the Policing and Disciplining of Accountants Employed by a Large Public Accounting Firm (Section 5109.5 of the Business and Professions Code).
- Report on Review of Implementation of New Licensing Requirements (Section 5000 of the Business and Professions Code).
- Report on Review of Peer Review Requirements (Section 5076 of the Business and Professions Code).

## II. EXECUTIVE SUMMARY.

### A. DISCIPLINING LARGE PUBLIC ACCOUNTING FIRMS.

#### 1. FINDINGS.

The CBA is unique in California insofar as it regulates both individuals and firms. The largest firms, known as the “Big Four,” are not just some of the largest firms in this state and the United States, but in the entire world. In addition to the Big Four, a significant group of mid-size firms also exists. In their global offices, Big Four and mid-size firms may employ CPAs licensed by 54 U.S. jurisdictions as well as individuals licensed by other countries.

Oversight of large firms, including individuals employed by those firms, presents considerable challenges in budgeting and funding for the extensive, ever-fluctuating investigative and legal resources required to pursue large matters. These barriers are compounded by a cumbersome state contracting process, the necessary acquisition and retention of outside legal resources and technical accounting expertise, lengthy legal procedural timelines, and the consumption of significant internal staff time in meeting all of the requirements of the state's administrative processes and procedures.

Confirming and proving an “audit failure” by a large firm is a rigorous undertaking, and investigations of complex audit engagements can consume several years and cost the CBA millions of dollars. To meet the challenges of pursuing large matters, the CBA needs a technically proficient staff of Investigative CPAs (ICPAs), ready access to technical consultants on complex accounting issues, and outside legal counsel. In the present disciplinary structure, no action exists between probation (and attendant terms) and license suspension/revocation. The current disciplinary model provides for probation on one margin of the spectrum and suspension/revocation on the other end. To address this concern, the Board is evaluating whether to establish disciplinary fining authority to be assessed in addition to any other penalties or sanctions against audit firms. The Board would need to seek the necessary authority to impose those sanctions as warranted. It expects to have a recommendation regarding this issue by November 1, 2003.

The CBA's annual Enforcement Program budget for complex case matters is approximately \$2 million. Because this amount is appropriated annually, but not always expended, any portion of this \$2 million not spent during the budget year cannot be held over for the next year. However, when a large matter occurs, generating the extreme funding demands that such a case requires, \$2 million can be spent quickly in pursuing a single case. Under current spending authority restrictions, present resource limitations would preclude or severely hamper the CBA from actively investigating and prosecuting more than one large firm case at a time.

Given the complex technical accounting issues that arise in large firm cases, it is critical that the CBA's enforcement staff include a sufficient number of ICPAs who are skilled in both accounting and the nuances of enforcement. Currently, due to the hiring freeze and budget control provisions, the CBA has an insufficient number of qualified ICPAs to pursue multiple large firm matters and simultaneously handle the increased workload created by reform legislation.

## **2. RECOMMENDATIONS.**

To address the core challenges to policing large firms and achieve the full benefit of the reform legislation, it is critical that the CBA obtain multi-year funding flexibility for complex enforcement matters and the ability to hire and retain a sufficient number of qualified ICPAs. Therefore, the CBA makes the following recommendations:

### **a. OBTAIN FUNDING FLEXIBILITY.**

- The CBA recommends legislation to afford it the ability to trigger access to \$2 million in necessary funds in a given budget year should those fiscal resources be required to continue pursuing one or more complex enforcement matters.
- The Board seeks statutory authority to encumber funds for specific investigative contracts to span at least a 24-month period.
- The Board seeks to increase the CBA's maximum fund reserve to an amount equal to nine months' operating budget, and to prohibit these funds from being used for other than CBA fund purposes.

### **b. HIRE AND RETAIN SUFFICIENT AND QUALIFIED ICPA STAFF.**

- The Board will seek reinstatement of the terminated ICPA position with a budget change proposal (BCP) to be initiated for fiscal year 2004-2005, at the request of the State and Consumer Services Agency.
- The Board will seek creation of three new ICPA positions to review new, expanded reportable events information, initiate investigations where determined appropriate, and to liaison with national and federal entities relative to their investigative activities and development of professional standards. A BCP toward this effort will be initiated for fiscal year 2004-2005, at the request of the State and Consumer Services Agency.
- The Board will continue to seek the establishment of reasonable salary parity for the ICPA classification.

## **B. LICENSURE PROGRAM BACKGROUND/FINDINGS.**

### **1. FINDINGS.**

The statutory changes that became effective on January 1, 2002, have resulted in significant changes to the education, examination, and experience requirements for licensure as a Certified Public Accountant in California. Most significantly, California now allows for obtaining a CPA license without satisfying an audit experience requirement. Previously, there was only one path to licensure; however, California applicants currently can choose from three pathway options for licensure.

While the new pathways provided applicants various options for becoming California licensees, the implementation efforts to put the new pathway system in place created heavy demands on the Board's limited resources and resulted in significant workload increases in all areas of the Board's Licensing Division. The inability to address this increased workload was exacerbated by the initiation of the statewide hiring freeze in October 2001.

The consequences of the staff reductions coupled with the workload boost are increased delays in processing licensure applications, renewal applications, certifications of exam, and licensure information to other parties, as well as slower responses to e-mails and telephone calls. In fact, time frames for processing applications for licensure, certification and license renewal will continue to be longer than those in existence when the Board was completely staffed, and the changes in licensing requirements had not yet been enacted. If the current circumstances continue, the Board may be unable to comply with its regulatory time frames for processing applications.

## 2. RECOMMENDATION.

- The new licensure requirements have only been recently implemented, and the CBA will administer its last paper-and-pencil CPA exam in November 2003. As a result, it is difficult to predict at this time what long-term staffing and other resources will be required for the board to effectively and efficiently perform its licensing functions. Therefore, the Board recommends issuing a follow-up, supplemental report at an appropriate time in the future, when adequate data is available, should the Board conclude that additional staffing or funding are required.

## C. PEER REVIEW REQUIREMENTS.

### 1. FINDINGS.

Current law requires the CBA to determine whether there is a need to implement a mandatory peer review program in California because of recent changes in federal laws, state statutes and regulations, and professional standards, and to submit a report of its findings to the Legislature.

Late in 2002, the Board established its Peer Review Task Force (PRTF), comprised of four CPAs and three public members. It held two public meetings in 2003, and it reviewed and studied all information related to peer review, including all state and federal statutory reforms, history of peer review in California, passage and implications of the federal Sarbanes-Oxley Act, implementation of the Public Company Accounting Oversight Board (PCAOB), status of proposed changes to the American Institute of Certified Public Accountants' (AICPA) peer review program, and other related subjects. The task force remains in effect, with work still to be accomplished.

In evaluating a mandatory peer review program, the PRTF investigated three issues that require significant additional information not yet available:

- a. Inspection requirements for non-public company audits.
- b. The level of risk posed by firms' auditing non-public companies, and
- c. The AICPA's review standards, which are being finalized.

### 2. RECOMMENDATION.

Because federal and state statutory and regulatory changes recently took effect and are still in the process of being implemented, and proposed revisions to the national peer review standards have not been finalized, insufficient information is available to determine whether a mandatory peer review program in California is necessary. As a result, the Board has provided this interim report and it recommends that the final report to the Legislature be assigned a due date of September 1, 2005, with a peer review implementation date of July 1, 2008, should a mandatory peer review or inspection program be mandated.

### III. ENFORCEMENT

#### Report on Problems with Respect to the Policing and Disciplining of Accountants Employed by a Large Public Accounting Firm

(Mandated by Section 5109.5 of the Business and Professions Code)

#### INTRODUCTION.

Public accountancy has been a regulated profession in California for more than a century. Yet at no other time has this profession been the focus of so much public scrutiny and serious concern, not only in California but nationwide. This is due to an unprecedented series of recent corporate collapses and related allegations of audit failures performed by several leading accounting firms. These bankruptcies in turn have negatively affected state, national and international markets, destabilized the financial foundation of many consumers — including reducing the value of savings, investments, pension plans, and profit-sharing plans — and have substantially contributed to increasing doubts about the integrity of the accounting profession.

Corporate failures, coupled with an increasing number of financial statement restatements and accounting irregularities, have led to significant accountancy reform legislation at both the state and federal levels. In California, three major bills were enacted in 2002.<sup>1</sup> These reform statutes and the regulations developed to implement them are significantly transforming the regulation of this profession in California. This transformation will continue to evolve through the next several years, and the funding and staffing levels of this Board will be key to the success of the reforms just enacted.

This report addresses the mandate of Assembly Bill 270, requiring the California Board of Accountancy (CBA) to report to the Legislature on problems relating to the regulating and disciplining of accountants employed by a large public accounting firm. While AB 270 does not define “large public accounting firm,” this report will examine the difficulties of disciplining firms that handle complex matters regarding the audits of publicly-traded companies, financial institutions (such as banks and savings and loans), governmental entities (such as school districts and cities or counties), and charitable entities. Generally, these complex audits, particularly those involving publicly-traded companies, are undertaken by the larger firms.

The CBA is unique in California as a regulatory entity because it regulates not only individuals but also firms. While this Board licenses and regulates more than 63,000 individual certified public accountants and public accountants, it also licenses approximately 4,500 accountancy firms (partnerships and corporations). The largest of these firms, frequently identified as the Big Four, are Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. Each is a multi-state and global practitioner. As four of the largest firms not just in this country but in the entire world, they employ in aggregate approximately 12,000 partners in the United States, and those partners manage approximately 120,000 to 130,000 CPAs nationally. In addition to the Big Four, a significant group of mid-size firms also exists. These larger firms (both Big Four and

<sup>1</sup> AB 2873 by Assembly Members Frommer and Correa (Chapter 230, Statutes of 2002).  
AB 2970 by Assembly Member Wayne (Chapter 232, Statutes of 2002).  
AB 270 by Assembly Member Correa (Chapter 231, Statutes of 2002).



mid-size), with their world-wide offices, may employ CPAs licensed by 54 separate United States jurisdictions, as well as individuals licensed by other countries, such as chartered accountants. It is important to note that if an accounting firm is licensed in California, its partners and CPAs may work on engagements in California. Some partners and CPAs in these companies also individually may be licensed in California, while others are not.

In a substantial engagement, such as audit of a huge corporate entity — for instance, a national or international communications corporation or banking concern — the engagement may be headquartered in a U.S. city (such as Chicago, Houston, or New York), with subsidiaries in other cities (such as Los Angeles or San Francisco). If the California Board of Accountancy initiates an investigation and subsequently files an accusation, taking on such a matter — and commanding the resources to do so — is comparable in size and effort to the federal government's pursuit of its case against Microsoft.

The Board's highest priority is to foster consumer protection. Yet the success of its endeavors is directly connected to the enforceability of the California Accountancy Act and Accountancy Regulations. In turn, the Board's ability to enforce is in part dependent upon access to the appropriate level of necessary resources. Pursuing complex matters against large and mid-sized firms requires extraordinary expenditures of time, staffing, and fiscal resources — all significant concerns that are addressed in this report.

## OVERVIEW OF CURRENT ENFORCEMENT PROGRAM PROCESSES AND RESOURCES.

Previous sunset review reports issued by the CBA have described its Enforcement Program and related processes in detail. However, for convenience, Appendix I to this report provides three flow charts summarizing the procedures and courses of action involved in investigating and pursuing cases.

This Board is — and has been — fully committed to meeting its mandate of consumer protection, and it has been successful in pursuing existing cases and initiating new cases, as well as recently providing several new means by which complaint information can be submitted to the CBA (for instance, via the Internet interactive process, an expanded public outreach program, and partnering with other state and federal agencies). In both the near and longer-term past, it has achieved positive outcomes in pursuing larger matters, despite the complexity of the legal issues and the tremendous fiscal challenges to its ability to prevail.

In the past 12 years, the CBA has prosecuted auditors in nine complex matters. These matters include the audits performed by very large firms such as Main Hurdman's audits of Technical Equities Corp, Arthur Young and Co.'s and Arthur Andersen's audits of Lincoln Savings and Loan, Laventhol & Horwath's audit of Budget Furniture Rentals, Inc., and KPMG LLP's audits of the 1992 and 1993 financial statements of Orange County.

Effective September 23, 2002, the CBA revoked the license of Arthur Andersen LLP. The revocation was based upon Arthur Andersen LLP's conduct in connection with its Enron Corporation engagements and the related criminal proceeding against Arthur Andersen LLP resulting in a jury verdict of guilty in the United States District Court for felony obstruction of justice.



In reference to the KPMG matter, which is still on-going, the CBA is the only state regulatory board in the nation to have ever placed a major firm on probation. Effective August 24, 2002, this firm was placed on one year's probation, with terms requiring KPMG to reimburse the CBA \$1,814,678 as the CBA's reasonable prehearing costs. While \$1.8 million may appear to be a large sum, it represents only a fraction of the actual costs of pursuing a complex matter. Appendix II to this report provides a case chronology, documenting the tremendous resources required to pursue this matter.

#### COMPARISON OF RESOURCE REQUIREMENTS FOR "SMALL" VS. "LARGE/COMPLEX" MATTERS.

To clarify the differences between the types of matters investigated by the CBA, especially in terms of the resources required to pursue these cases, the following information is provided:

- Non-large firm accounting matters.
  - ♦ CBA annually disciplines an average of 30 - 50 licensees.
  - ♦ Each matter requires between 20 - 100 Investigative CPA (ICPA) hours.
  - ♦ Each matter generally includes one investigative hearing, with participation by a Deputy Attorney General (DAG) and experts in the practice area from the CBA's Administrative Committee.
  - ♦ When warranted, cases are referred to the Attorney General (AG) for the drafting of an accusation.
  - ♦ Approximately 75 percent of these cases are resolved by a default decision or a stipulated settlement, while the remainder are heard before an administrative law judge.
  - ♦ Depending upon several factors, the cost per case ranges from \$5,000 to approximately \$75,000.
- Large Accounting Firms/Complex Cases.

An enforcement matter involving these very large firms does not occur every year. However, when it does, generally it is a huge undertaking. These complex matters usually are identified initially through disclosures by the news media or through publicly-available court documents (such as civil filings), information sources routinely monitored by enforcement personnel. Assembly Bill 270's expanded reportable events requirements also will bring much more information to the CBA, and it is anticipated that these documents will provide earlier insight into whether further investigation of the matter is warranted.

- ♦ Experience indicates that it may take three to seven years to bring such a matter to the point of discipline, at a cost of one to 10 million dollars, if contested.
- ♦ At a minimum, at least one Investigative CPA is required full-time over multiple years.

- ♦ Other required resources include:
  - Contracting for multiple consultants specializing in the practice area in question. The immediate hiring of consultants with the requisite expertise, early in the process, to assist throughout the investigation, is critical to the CBA's cases and difficult to achieve with current contracting constraints.
  - Multiple investigative hearings with the associated expenses of attorneys, consultants, and court reporters.
  - Dedication of a legal team from the AG's office and, as appropriate, contracting for outside counsel to serve as co-counsel with the DAGs assigned to the matter. CBA's use of outside counsel is unique within DCA's licensing boards and bureaus. The tremendous size of larger firms and their near limitless resources make it essential that CBA has the ability to use outside counsel.
- ♦ Cost of such a case depends upon whether it is resolved through a stipulated settlement, or it proceeds to administrative hearing — and the presence and volume of related civil filings and associated Public Records Act requests, both of which significantly escalate costs.
- ♦ In matters going to hearing, the case may then be appealed to California Superior Court, Court of Appeal, and the Supreme Court, all of which result in significant additional costs to the CBA.

## CORE CHALLENGES TO IMPLEMENTATION OF REFORM LEGISLATION.

The CBA is a relatively small \$11 million entity charged with regulating some of the largest firms in the world. It has the intent and the will to implement the provisions of the newest reforms — legislation which now substantially increases the flow of information to this Board — but budgetary and staffing constraints substantially hamper its ability to respond to the demands of complex cases. At this time, it certainly is not equipped nor positioned to proactively initiate more than one complex matter at a given time, without a massive dislocation of resources and attendant delays that would undermine the CBA's enforcement efforts in these and other areas.

Oversight of large firms, including individuals employed by those firms, presents considerable challenges in budgeting and funding for the extensive, ever-fluctuating investigative and legal resources required to pursue these matters. These barriers are compounded by a cumbersome state contracting process, the necessary acquisition and retention of outside legal resources and technical accounting expertise, lengthy legal procedural timelines, and the consumption of significant internal staff time in meeting all of the requirements of the state's administrative processes and procedures.

Confirming and proving an “audit failure” by a large firm is a precise and rigorous undertaking, requiring the CBA to obtain clear and convincing evidence of an extreme departure from a set of professional standards that are replete with “professional judgment.” Historically, this determination has included judgment about the specific audit work the auditor chose to document, and the specific documentation the auditor chose to retain. It is anticipated that the new audit

documentation requirements provided by AB 2873 will ease this evidential challenge. Nonetheless, investigations of complex audit engagements can consume several years, involve significant difficulty in accessing records, and cost the CBA millions of dollars. Disciplinary hearings and subsequent appeal proceedings can cost millions more. The KPMG case cited earlier is illustrative of what is entailed in pursuing such a complex matter in a contested context.

While the cost of investigating a complex audit performed by a large firm is substantial, that expense is much less than the expenditures to litigate that matter through administrative hearings and subsequent appeal hearings. These proceedings, with the associated expenses of related civil actions and Public Records Act requests, can take millions of dollars more. It should be noted that although the costs of an investigation may be recovered, generally litigation costs are not recoverable.

Once the CBA completes its investigation and concludes that a large firm has committed violations of the Accountancy Act, determining the appropriate discipline for the accounting firm presents additional challenges. As explained previously, a single Big Four accounting firm can employ thousands of partners as well as tens of thousands of licensed CPAs, and possess a vast client base. Revocation, or even suspension, of a firm's permit to practice would significantly impact large numbers of the firm's employees and many clients, most of whom have no connection with the conduct that resulted in the violations. The challenge before this Board is to determine appropriate sanctions or penalties for major audit firms.

Imposing probation, as in the KPMG case, is the general outcome of a complex case, if that case is pursued to conclusion. In the present disciplinary structure, no action exists between probation (and attendant terms) and license suspension/revocation. The current disciplinary model provides for probation on one margin of the spectrum and suspension/revocation on the other end. To address this concern, the Board is evaluating whether to establish disciplinary fining authority to be assessed in addition to any other penalties or sanctions against audit firms. The Board would need to seek the necessary authority to impose those sanctions as warranted. It expects to have a recommendation regarding this issue by November 1, 2003.

#### EXPENDITURE AUTHORITY AND THE CONTRACTING PROCESS.

The approval process for increased expenditure authority in any given year has proven to be overly burdensome, given that cost escalations in these matters are beyond the CBA's control. As stated previously, costs of these cases can escalate rapidly when responding to civil lawsuits filed for injunctive relief, complying with massive Public Records Act requests, and participating in an extensive administrative hearing process, in which state attorneys may face a litigation team of six or more trial counsel accompanied by a team of technical experts and substantial support staff.

Currently, when the services of consultants and outside counsel are needed, the contracting process takes three to six months, constituting lost time in the investigation and prosecutorial phases. Lost time increases the risk of loss of evidence and witnesses, and it provides respondent firms with added time to bolster their defensive positions.

The CBA needs ready access to technical consultants and outside legal counsel to successfully investigate and prosecute large firm cases, as large accounting firms have seemingly unlimited resources to counter a disciplinary action. Due to the complexity of the issues involved and the tremendous volume of resources applied by respondent firms, it is essential that the CBA employ

technical experts and outside counsel to successfully pursue a complex case prosecution. At present, the CBA's annual Enforcement Program budget for complex case matters is approximately \$2 million — a sum that is not always expended yearly. Because this amount is appropriated annually, any portion of this \$2 million not spent during the budget year cannot be held over for the next year. However, when a large matter occurs, generating the extreme funding demands that such a case requires, \$2 million dollars can be spent quickly in pursuing a single case. Under current spending authority restrictions, present resource limitations would preclude or severely hamper the CBA from actively investigating and prosecuting more than one large firm case at a time.

To obtain additional funding, the Board must process a "Deficiency Request" through several control agencies — the Department of Consumer Affairs, State and Consumer Services Agency, and Department of Finance. This procedure requires a significant dedication of staff resources and months to achieve. In the meantime, the CBA is placed in the awkward situation of either having to commit dollars in advance of the approval process being completed or putting the litigation process on hold, neither of which is a sound position.

#### RESPONSIVE FUNDING MECHANISMS/EMERGENCY ALLOCATION PROCESS.

While regulating large firms, including the individual CPAs employed by them, presents enormous challenges in terms accessing funding, as well as securing staff and contracted resources, the CBA's statutory mandate demands that enforcement be directed consistently and equitably. In the past, the Board has successfully overcome the bureaucratic constraints of conducting complex cases, but at a cost of consuming resources that could better have been employed in actually pursuing the case itself. This Board does not want to be placed in the position of being forced to abandon a case — especially a matter to which the CBA has already dedicated significant time and funds — for lack of resources. If such a situation were to occur, it would send a clear message to the accounting profession that if an entity possesses sufficient resources, it will be able to derail or even avoid disciplinary action by the California Board of Accountancy.

It is critical that the CBA not be restricted in its enforcement activities to taking action only against firms that choose not to dispute the disciplinary process or lack the resources to do so. In any situation in which significant potential harm has affected consumers, the CBA should be able to engage the entire weight of the law against the offending party, in order to protect other consumers from suffering a similar loss. To mitigate these difficulties, the Board has sought and will continue to seek multi-year budget authority for complex enforcement matters, reinstatement of the terminated investigator position, acquisition of more Investigative CPA positions, and reasonable salary parity for the ICPAs who are necessary to relieve the impacts of these present barriers.

#### MORE INFORMATION, FEWER RESOURCES.

Currently, in the whole of the state, there are only five ICPAs and one supervising ICPA, in contrast to more than 67,000 licensed CPA individuals and firms — such a tiny number that a comparison of the number of investigators versus licensees is statistically microscopic. In addition, the hiring freeze resulting from the state's fiscal crisis has resulted in the loss of an Investigative CPA position that was vacated due to the death of the incumbent one year ago. As the position was unfilled on July 1, 2002, it was eliminated due to a state budget control provision. A Budget

Change Proposal (BCP) to restore this position was turned back by the Department of Finance in early August 2003. On August 20, 2003, the Board received information from the Department of Consumer Affairs that the State and Consumer Services Agency would be requesting Department of Finance's reconsideration of the BCP seeking restoration of the lost ICPA position. However, at present, the outcome of this effort cannot be known.

While staff resources have been reduced, reform legislation has resulted in a substantial increase in enforcement workload. Many of these reforms, such as expanded reportable events for restatements and civil judgments (Business and Professions Code Section 5063), require additional enforcement resources. For example, in just six months, the Enforcement Program has felt the impact of the reform provisions. As of June 2003, the CBA had received 76 reports related to the new requirements, the majority of which have been restated financial statements. Enforcement personnel currently are attempting to complete a meaningful review and evaluation of these reports as they are received to determine their importance and pertinence relative to the CBA's regulatory responsibilities. However, the shortage in staff ICPAs has limited our response to logging of the reports and a summary inspection. The CBA estimates an annual inflow of 300 to 500 reportable events, once knowledge of the reporting requirements become more widespread and understood. Plainly said, more external information is flowing into the CBA, but diminished resources make it very difficult to take advantage of this data.

Given that a fully staffed, knowledgeable, and seasoned Enforcement Program has yielded strong results in the past, the elimination of just one ICPA position has been and will continue to be extremely detrimental to the efficiency and future success of the program. Therefore, in addition to seeking the restoration of the lost position, the Board also has determined the need for three new ICPA positions. The three ICPA positions were added to the Legislature's 2003-2004 budget by Senate Budget Subcommittee No. 4; however, on July 27, 2003, the Senate removed the positions and transferred the funds that would have been dedicated to three ICPAs to the General Fund, as a loan. The Board intends to submit a BCP for these new positions next fiscal year. Further, as the Board receives more information under the reform legislation, it is extremely likely that additional positions will be required. (Please see Appendix III for a chronology of the Board's activities and initiatives to retain and acquire necessary resources. It is expected that this document will be updated semi-annually to document the Board's efforts in this regard.)

It had been anticipated that one of the four sought positions would be committed in part to national activities in working with both the PCAOB as well as the standard-setting entities, including the American Institute of Certified Public Accountants (AICPA). This new position would liaison with the PCAOB to form an effective working relationship, establish communication links, and develop processes for the quick flow of information between the two agencies, for the purpose of enhancing and supporting the Board's enforcement cases. A closer association with the PCAOB not only would result in a stronger Enforcement Program toward protection of the consumer, but also it would help assure that California is an important, contributing agency to the regulation of the profession.

As recent events have demonstrated, the profession's self-regulating model requires more active participation of the regulators in the audit and accounting standard-setting process which predominantly occurs nationally. While the Board has consistently corresponded with and commented to the SEC, the AICPA, and other national bodies on proposed rules, standards, and exposure drafts, an ICPA partly dedicated to this interface would constitute a valuable, effective, and much-needed liaison with these entities so that California's voice is heard and considered. The Board bears a noteworthy share of that regulatory responsibility because of the size of California's economy and the large number of CPAs licensed in this state.



## RECRUITING AND RETAINING THE INVESTIGATIVE CPA (ICPA).

The Investigative ICPA is the “backbone” of the investigative process. A unique classification, these investigators are highly skilled and extensively trained in accounting standards, as well as the examination and review of workpapers and reports on audits, reviewed and compiled financial statements, income tax filings, and other documents related to professional accountancy services. In addition, they are specially trained in the nuances of investigative techniques, and they may even serve as expert witnesses when appropriate. They bring their particular expertise to each complaint they investigate and every case to which they are assigned. The question must be asked, “Why are there so few ICPAs?”

First, simply recruiting candidates to test for this position has proven tremendously expensive in dollars, effort, and time — producing unsatisfactory results. In the past two years, the DCA completed two full statewide exam cycles. Each attempt involved extensive advertisement, as well as the development and execution of written and oral examinations. Of approximately 36,000 California CPAs (active licensees) directly contacted by letter for the 2000 exam, only 28 took the written exam, four passed and eventually made the list, and one of those eventually declined the hiring interview due to the low compensation. For the 2001 exam, 36,000 actively-licensed California CPAs were again contacted. Only 25 candidates applied and sat for the 2001 written exam, with 12 passing. Of those 12, only 10 candidates took the oral portion of the exam. Seven passed the oral and were placed on the list but shortly thereafter three candidates, including the two most promising, dropped out stating that the compensation was insufficient.

As established earlier, an inadequate salary structure has been the largest obstacle in recruitment and retention of the ICPA. The salaries in this class are extremely small in comparison to that of a SEC investigator or a CPA firm partner. At the civil service level, even other state service positions offer substantially higher pay for far less technically demanding assignments. In fact, in the last two years, the CBA lost two of its most experienced investigators to other state government positions for this very reason. While the two positions eventually were refilled (prior to the current hiring freeze), after extensive recruitment and examination, it is important to note that a minimum of two years is required for a CPA Investigator to become adequately proficient to handle cases.

If the Enforcement Program is both to recruit and retain a technically proficient staff of ICPAs, the compensation for this classification must be increased to provide reasonable parity with the salaries of others in state and federal government service with comparable responsibilities and required competencies. In addition, to meet the demands of the increasing flow of self-reported information generated by the reform legislation, as well as to adequately address the licensee population of the CBA, the number of ICPAs must be increased.

To resolve the recruitment crisis for the Investigative CPA classification, the CBA — through the Department of Consumer Affairs — developed the necessary documentation requesting a salary realignment for submission to the Department of Personnel Administration. Unfortunately, this package was returned without consideration. Absent salary parity, it is likely that further exodus of experienced investigators will be widespread once the hiring freeze is lifted, and perhaps even before, should these investigators choose to seek other employment opportunities. While the current state fiscal crisis has prevented the processing of the request, it is hoped that the importance of this classification will be acknowledged, resulting in a reasonable, fair salary increase.

Looking to the future, obtaining and retaining sufficient professional investigative staff would allow CBA to possess the ability to “grow” its own internal personnel resources to institutionalize the knowledge and expertise necessary to expeditiously pursue all enforcement matters. Each complaint and each matter must be treated as unique and given the appropriate amount of scrutiny and resource dedication as necessary for proper resolution. In investigating and pursuing complex matters, for the ICPA to reach sufficient expertise and proficiency, he or she must be given requisite time to gain the experience to mature professionally. Only through consistent retention of ICPA staff will this Board acquire the means to conduct the enforcement activities it is charged with performing, especially in relation to complex matters.

## RECOMMENDATIONS TOWARD ENHANCED CONSUMER PROTECTION.

Because there can be no shortcuts in the investigative and prosecutorial processes, greater flexibility in accessing funding is essential to stronger consumer protection. The CBA's ability to effectively pursue any and all enforcement disciplinary matters holds far-reaching policy implications for not only this agency, but also for California's consumer public. It relies upon the force of current law and its delegated state government agency to provide the licensing and enforcement activities performed by the CBA in accordance with the Accountancy Act and Accountancy Regulations.

To address the core challenges to policing large firms, the Board is making several recommendations it believes would more strongly position it to achieve the full benefit of the reform legislation, acquire it the professional investigative staff it needs to maintain and amplify its Enforcement Program, and obtain multi-year funding flexibility to meet the rigorous demands of pursuing complex matters. In addition, the Board is evaluating whether to seek the ability to impose additional sanctions against audit firms when warranted.

### 1. OBTAIN FUNDING FLEXIBILITY.

In the past, the CBA has been hampered by an inflexible and time-consuming process to acquire the expenditure authority it needs to pursue a complex matter. In seeking these approvals, the large amount of time required to create and process these approvals would have been better spent in pursuing the case.

#### Recommendation 1A:

**The CBA recommends legislation to afford it the ability to trigger access to \$2 million in necessary funds in a given budget year — should those fiscal resources be required to continue pursuing a complex matter.**

This funding trigger would be developed to permit the delegation to the Department of Finance of a one-time, current year augmentation of up to \$2 million in a given budget year to be allocated through one, two, or three specific budget line items — The Attorney General's Office, Professional and Consulting Services, and the Office of Administrative Hearings. The CBA would be required to substantiate the public protection need for the funding, show that the funding shortfall was not foreseeable, and demonstrate it could not be addressed through the regular budget process. Requests above the \$2 million ceiling would require notification of the Legislature.



This method would avoid restrictions on pursuing a viable enforcement matter due to an unforeseeable budget shortfall. Importantly, the integrity of the allocation would be protected both by oversight by a control agency and by its limit in duration and amount. Earlier this year, a similar process was proposed for one of the DCA boards, and it was preliminarily examined by the staff of the Joint Legislative Sunset Review Committee. While the concept did not go forward, this Board believes this mechanism would provide an effective, responsible means to provide spending authority when needed for complex case activities.

#### **Recommendation 1B:**

**The Board seeks statutory authority to encumber funds for specific investigative contracts to span at least a 24-month period.**

Currently, dollars not expended by June 30 revert to the Board's reserve fund. To secure funding for ongoing matters, the encumbrance process begins again for the fiscal year — midstream in the case activity. Securing authority to fund specific case contracts over at least two fiscal years provides resource flexibility as well as the security of assurance that dollars will be available to continue the uninterrupted pursuit of a complex matter.

#### **Recommendation 1C:**

**The Board seeks to increase CBA's maximum fund reserve to an amount equal to nine months' operating budget, and to prohibit these funds from being used for other than CBA fund purposes.**

This package of adjustments is essential to provide the CBA with the tools to regulate and discipline large firms and accountants employed by large firms. Without adequate investigative resources, the full potential benefit of the reform legislation cannot be realized. With its strengthened enforcement program, the CBA possesses adequate legal authority to pursue complex matters. However, to maximize its effectiveness and meet its consumer protection mandate, it needs the necessary spending authority and staff resources to regulate the contemporary practice of public accountancy.

#### **2. HIRE AND RETAIN SUFFICIENT AND QUALIFIED STAFF.**

The CBA seeks to maximize its effectiveness in implementing the requirements of reform legislation, as well as to effectively meet the challenges of regulating a licensee population of more than 67,000 CPA individuals and firms.

#### **Recommendation 2A:**

**The Board will seek reinstatement of the terminated ICPA position with a BCP to be initiated for fiscal year 2004-2005, at the request of the State and Consumer Services Agency.**

This position was lost as a result of the hiring freeze. While the position has gone, the workload formerly allocated to this position not only remains, but has been increased due to the effects of reform legislation.

**Recommendation 2B:**

**The Board will seek creation of three new ICPA positions to review new, expanded reportable events information, initiate investigations where determined appropriate, and to liaison with national and federal entities relative to their investigative activities and development of professional standards. A BCP toward this effort will be initiated for fiscal year 2004-2005, at the request of the State and Consumer Services Agency.**

Currently, staff only are able to log and generally review reportable events information. This influx of this data is expected to grow exponentially as licensees become more aware of the requirements to submit such information. As well, ICPA liaison activities with standard-setting and national regulating entities is desirable to responsibly represent California's interests. Finally, the Board is substantially understaffed with professional investigators in relation to the size of its licensee population. A staff increase would remedy this severely unbalanced ratio of investigators to licensees.

**Recommendation 2C:**

**The Board will continue to seek the establishment of reasonable salary parity for the ICPA classification.**

To recruit and retain ICPA staff, as well as to afford the Board the ability to "grow" its own professional resources and preserve institutional knowledge and expertise, immediate compensation parity for this classification is essential.

## IV. LICENSING

### Report on Review of Implementation of New Licensing Requirements

(Mandated by Section 5000 of the Business and Professions Code)

#### INTRODUCTION.

This document addresses the statutory requirement to report to the Legislature on the implementation of the new licensing requirements. It also discusses the Licensing Division's workload increases generated by the reforms, as well as the related program decisions that have been made by the Board.

The statutory changes that became effective on January 1, 2002, have resulted in significant changes to the education, examination, and experience requirements for licensure as a certified public accountant in California.

#### SUMMARY OF CHANGES.

Most significantly, California now allows for obtaining the CPA license without satisfying an audit experience requirement. Previously, there was only one path for licensure; now California applicants may choose from three pathway options:

- Pathway 0 — Former requirements with mandatory audit experience.
- Pathway 1 — Increased minimum education requirement, and two years general accounting or audit experience.
- Pathway 2 — Uniform Accountancy Act (UAA) education requirement, and one year general accounting or audit experience.

Prior to 2002, **Pathway 0** required all applicants to satisfy an audit experience requirement. Depending upon the applicant's education, two to four years of experience were required for licensure. Under Pathway 0, applicants are required to apply and qualify for licensure by December 31, 2005. If the applicant does not apply and qualify by December 31, 2005, the candidate must satisfy the increased educational requirements, retake all sections of the CPA examination, and reapply for licensure under Pathway 1 or Pathway 2.

**Pathway 1** licensure requirements are similar to the prior requirements except that a baccalaureate degree is the minimum educational requirement. Two years of general accounting experience are required for licensure, and a minimum of 500 hours of audit experience is required for those who want to sign attest reports.

**Pathway 2** licensure requirements are consistent with the UAA. This is the pathway of choice for those candidates who are interested in the opportunity to practice in other states. One year of

general accounting experience and 150 semester hours of education (including a baccalaureate degree) are required for licensure, and a minimum of 500 hours of audit experience is required for those who want to sign attest reports.

Appendix IV provides a comparison of the education, examination, and licensure requirements of the three pathways.

The following statistics summarize the number of licenses issued under each pathway from January through December 2002.

Type of Experience	Pathway 0	Pathway 1	Pathway 2
Audit	426	1,078	175
General	Not Applicable	732	317
<b>Total</b>	426	1,810	492

Licensing data shows that during the first six months of 2003, approximately 50 percent of individuals applying for licensure as a CPA in California selected the alternative of not having to satisfy an audit experience requirement. However, it should be noted that while the above statistics reflect individuals' selected licensing pathways during the first year of implementation, one year's data does not provide sufficient information to predict future licensing trends.

#### **FINDINGS: IMPLEMENTING THE NEW REQUIREMENTS.**

While the new licensing pathways provided applicants various, career-relevant options to become California licensees, the implementation efforts to put the new pathway system in place created heavy demands on the Board's limited resources and resulted in significant workload increases in all areas of the Board's Licensing Division.

As soon as the new licensing requirements were enacted, the Board took immediate action to notify applicants and other interested parties of the new requirements:

- A task force consisting of members of the Board and Board Committees, educators, and representatives of the profession was established to assist in the development of procedures and regulations to implement the new requirements. The Board subsequently adopted implementing regulations.
- A letter was mailed to all exam candidates and individuals with pending licensure applications, notifying them of important changes to the licensing requirements and additional options for licensure. This letter was posted on the Board's Web site.
- An informational flyer conveying the new licensing requirements was prepared and mailed to California colleges and universities, professional associations, and other interested parties. This information also was posted to the Board's Web site.
- A technical hotline and an e-mail address were established and staffed to address questions regarding the new licensing requirements.

- On numerous occasions, to provide personalized guidance on the new licensing requirements and pathway options, Board members and staff visited statewide college campuses and met face-to-face with hundreds of students and educators.

## RESULTANT WORKLOAD INCREASE.

As mentioned previously, the changes in the licensing requirements generated a major and unexpected upswing in workload for all areas of the Board's Licensing Division. The following documents the increase from January 2001 through December 2002.

Licensing Workload	2001	2002	2001 - 2002 Percentage Increase
Individual Licensing Applications	2,015	3,337	66%
E-Mail Inquiries	20,508	29,678	45%
Telephone Calls	72,050	74,930	4%
Certifications	1,306	2,538	94%
Initial Renewal Applications	24,537	26,283	7%

Adding to the resultant difficulties from the higher workload, the ability to address the increase was exacerbated by the advent of the statewide hiring freeze in October 2001. As a direct consequence of the current hiring freeze, which has been extended through July 2005, the Licensing Division lost one permanent full-time position at the beginning of the current fiscal year, as well as the services of a student assistant. Additionally, the Licensing Division presently has three vacant positions that cannot be filled due to the hiring freeze, and it is anticipated that the Department of Finance will eliminate all three of these full-time permanent positions as part of the 12 percent personal services reduction being implemented to address the statewide budget problem.

Today, the consequences of the reduction in staff, in conjunction with the boost in workload, are ever-increasing delays in the processing of applications for licensure, renewal applications, certifications of exam, and licensure information to other parties, as well as slower responses to e-mails and telephone calls. Currently, it is taking an average of six to eight months to process licensure applications, six to eight weeks to process renewal applications, five to 10 days to respond to phone or e-mail inquiries, and approximately eight weeks to complete a certification. In contrast, the time frames prior to the workload increases were three to six months to process licensure applications, one to two weeks to process renewal applications, 48 hours to respond to telephone inquiries, two to five days to respond to e-mail inquiries, and two to four weeks to complete a certification.

## RECENT PROGRAM MODIFICATIONS.

Four core functions are essential to the consumer protection mission of the Board: examination, licensure, renewal, and enforcement. In March 2003, following much discussion and consideration, staff received the following direction from the Board regarding those activities that could be modified without significant detriment to the integrity of these core functions.

- Adjust the process regarding continuing education forms submitted by licensees for renewal by continuing to collect the forms but suspending the review of them. These forms will be held and, at some future time, should staffing resources be improved, it is intended that a random review of these documents will be reinstituted.
- Temporarily suspend the Report Quality Monitoring Program (RQMP). This program reviews financial statement reports and provides feedback to licensees and referrals to Enforcement if additional education does not bring licensees into compliance with standards. The proactive nature of this program received positive a reception during the Board's previous sunset review process.
- Recognize there will be an increase in the response time to phone calls and e-mails from 48 hours to five working days for phone calls and from five working days to 10 working days for e-mail inquiries.

These changes will bring staffing for the core functions to the approximate pre-freeze level. However, the steady influx of individual licensing applications that continues to be received by the Board in 2003 indicates the new pathway options for licensure will have a long-term impact on staff resources.

Further, while the Board cannot know the staffing implications of the launch of the computer-based CPA Examination in 2004, it is certain that some workload will decrease, some workload will increase, and some new functions, such as monitoring 14 testing sites throughout California, will materialize. The ultimate consequence of these workload increases is that time frames for processing applications for licensure, certification, and license renewal will continue to be notably longer than those in existence when the Board was fully staffed, and the changes in licensing requirements had not yet been enacted. If the current staffing constraints and the workload increases continue, the Board may be unable to fully comply with its regulatory time frames for processing applications.

## CONCLUSION.

Currently, the Board has lost two staff members in the Licensing Division, one a permanent full-time positions and one a student assistant, both of which have been eliminated. Further, the Board anticipates losing three additional full-time permanent positions as part of the 12 percent personal services reduction. When one considers that the Board's Licensing Division now has only 25 permanent positions, the loss of this number of staff and positions is potentially devastating.

It is expected that the Board will reevaluate workload constraints and staff vacancies at its November 2003 meeting. While the Department of Finance declined to consider a FY 2004-2005 budget change proposal requesting augmentation of the Board's budget for the full-time permanent position that was lost as of July 1, 2002, the Board will resubmit this BCP, as well as a request for the other lost positions, for FY 2005-2006.

When an initial license applicant spends four years completing higher education requirements, takes up to two years to pass the Uniform CPA Examination, and fulfills the experience requirement, he or she completes the application and pays the licensing fees. The full — and highly reasonable — expectation is that once all requirements have been met, the license should be promptly issued,

affording the CPA the means to legally practice the profession. To try to meet that expectation, staffing shortages have necessitated the shifting of workload priorities so that the license may be issued in a reasonably timely manner.

In the instance of license renewal, the necessity to postpone program functions or adjust workload efforts (such as suspending the RQMP and delaying the review of continuing education) has lead to concerns that the Board's ability to protect the consumer public is being compromised by the workload constraints outlined in this report. The elimination of activities designed to guard the consumer has not been an easy decision for this Board.

The attempt to balance workload needs with resource realities has necessitated complex and difficult choices in order to continue to provide the licensing core function of the Board. However, there is growing concern that if budget constraints are prolonged or increased, the Board is at risk of lacking resources to ensure proper oversight of the four core functions related to acquiring and renewing the CPA license.

Despite current severe staffing constraints, the Board continues its best efforts to assist applicants with their licensing endeavors and licensees with their renewals. However, the ultimate effect of licensing reforms coupled with staff cuts is that applicants, licensees, and consumers all are being underserved by the CBA.

#### **Recommendation.**

The new licensure requirements have only been recently implemented, and the CBA will administer its last paper-and-pencil CPA exam in November 2003. As a result, it is difficult to predict at this time what long-term staffing and other resources will be required for the Board to effectively and efficiently perform its licensing functions. Therefore, the Board recommends issuing a follow-up, supplemental report at an appropriate time in the future, when adequate data is available, should the Board conclude that additional staffing or funding are required.



## V. PEER REVIEW

### Report on Review of Peer Review Requirements

(Mandated by Section 5076 of the Business and Professions Code)

#### INTRODUCTION.

In 2001, AB 585 and SB 133 added section 5076 to the Business and Professions Code, requiring most accounting firms that provide attest services to complete a peer review before their first license expiration date after January 1, 2006, and every three years thereafter. Section 5076 also required the California Board of Accountancy to adopt detailed regulations governing the peer review process. These regulations would be reviewed by the Joint Legislative Sunset Review Committee at the Board's next sunset review.

In 2002, AB 270 further amended section 5076 to require the CBA to determine whether there is a need to implement a mandatory peer review program in California because of recent changes in federal laws, state statutes and regulations, and professional standards, and to submit a report of its findings by September 1, 2003.

Because federal and state statutory and regulatory changes recently took effect and are still in the process of being implemented, and proposed revisions to the national peer review standards have not been finalized, insufficient information is available to determine whether a mandatory peer review program in California is necessary. As a result, the Board is providing this interim report and recommending that the final report to the Legislature be assigned a due date of September 1, 2005, with a peer review implementation date of July 1, 2008, should a mandatory peer review or inspection program be mandated.

#### BACKGROUND INFORMATION.

The new peer review requirement was a result of the Board's 2000–2001 sunset review. In the CBA's *October 2000 Sunset Review Report*, the Board reported that fewer than 15 percent of its certified public accountant licensees provided attest services as their primary area of practice; consequently, the audit requirement for licensure no longer reflected the current public accounting environment. As a result, the Board proposed to eliminate the attest experience requirement for licensure. In part, this was intended to align California more closely with the Uniform Accountancy Act (UAA).

To offset this change in the experience requirement, the Board proposed implementation of mandatory peer review for firms that perform audits, reviews, or examinations of prospective financial information (so-called "attest firms"). Under the Board's proposal, to provide "attest" services, a firm must be licensed as an "attest firm" and — as a condition of license renewal — the attest firm would be required to undergo peer review in accordance with professional standards. The Board recommended that qualified peer review providers conduct peer review in accordance

with professional standards and with Board oversight. The Board reported that implementing a peer review program would significantly enhance consumer protection by reaching more licensees and providing a more complete assessment of a firm's work products and operations than was possible through its Report Quality Monitoring Program.

Therefore, as one result of the Board's 2000–2001 sunset review, the Legislature added section 5076 to the Business and Professions Code. In section 5076, the Legislature declined to enact the attest firm license requirement proposed by the Board, but imposed a triennial peer review requirement on firms providing attest services (other than small firms and sole proprietors), effective January 1, 2006. Section 5076 contains few details regarding the actual conduct of peer review; instead, it requires the Board to adopt regulations to implement the peer review requirement. SB 133 also extended the Board's sunset date to July 1, 2006, which would require a sunset hearing in the fall of 2004 and sunset legislation during 2005; language included in SB 133 stated that "it is the intent of the Legislature that prior to the next [sunset] review required by Division 1.2, the California Board of Accountancy develop regulations and procedures to implement the peer review requirement mandated by Section 5076." Thus, the legislature simply enacted a "barebones" peer review requirement, directed the Board to develop detailed regulations implementing the requirement prior to its next sunset review in the fall of 2004, and built in an additional opportunity for legislative review of the Board's implementing regulations prior to the January 1, 2006, effective date for mandatory peer review.

Subsequent to the passage of SB 133 and AB 585, the unprecedented audit failures at Enron and WorldCom during 2001–2002 focused nationwide attention on the inadequacies of "self-regulation" of the accounting profession and — in particular — the efficacy of peer review as a means of detecting faulty audit techniques and processes. Harvey Pitt, Chair of the U.S. Securities & Exchange Commission (SEC), called for a "major overhaul" in the traditional peer review system administered by the American Institute of Certified Public Accountants (AICPA), a private professional association. Mr. Pitt called for replacement of traditional peer review with "more frequent monitoring of audit quality and competence" performed by "permanent quality control staff" of a new accounting regulatory body dominated by non-CPAs. According to Mr. Pitt, such staff should be "knowledgeable people unaffiliated with any accounting firm," and "deployed and overseen by the new publicly dominated body and its staff."<sup>1</sup>

Enacted on July 30, 2002, the federal Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB) to oversee public accounting firms that perform audits of publicly traded companies. The PCAOB intends to replace the AICPA's Securities and Exchange Commission Practice Section (SECPS) peer review program with its own program of inspections. PCAOB staff will inspect all public accounting firms auditing public companies. Firms that audit 100 or more issuers of exchange traded securities will be inspected by the PCAOB every year, and firms that audit less than 100 issuers will be inspected every three years.

In line with Congress' enactment of the Sarbanes-Oxley Act, the California Legislature enacted several accounting reform measures in 2002. In light of the extensive criticism of the peer review process that emerged in the wake of the Enron/Andersen and WorldCom scandals, one of those bills — AB 270 — amended section 5076 to direct CBA to "review whether to implement the program specified in this section in light of the changes in federal and state law or regulations or professional standards," and to report its findings to the Legislature and to the Department of

<sup>1</sup> Public Statement of SEC Chair Harvey L. Pitt (Jan. 17, 2002).

Consumer Affairs by September 1, 2003. AB 270 also moved the Board's sunset review date forward by one year, calling for a sunset hearing during the fall of 2003.

## METHODOLOGY.

In late 2002, the Board established a Peer Review Task Force (PRTF) to study this issue and report its findings to the Board by July 2003. The PRTF consists of seven members, including four CPAs and three public members; four of the PRTF's members are not members of the CBA. The PRTF held public meetings in January and March 2003 and reviewed the following information:

- History of peer review and the UAA.
- History of peer review in California, including the findings of CBA's earlier Peer Review/Attest Firm Task Force and CBA's *2000 Sunset Review Report*.
- New statutory changes at the federal and state levels.
- Status of the implementation of the PCAOB's inspection program.
- Status of the proposed changes to the AICPA's peer review program for public accounting firms that provide attest services to nonpublic entities.
- Other states' peer review programs and proposed changes.

## FINDINGS.

### 1. HISTORY OF TRADITIONAL PEER REVIEW.

Traditionally, the AICPA — a private, nongovernmental professional association — has required peer review for admittance and ongoing membership for firms performing attest functions. The precursor to the mandatory peer review program for admittance to membership was the formation of two practice sections in 1977 in which membership was held by firms rather than individuals. These sections were the SEC Practice Section (SECPS) and the Private Company Practice Section (PCPS). The SECPS and PCPS required mandatory peer review for all of their member firms at a time when peer review was not an AICPA membership requirement. The AICPA established these voluntary quality assurance programs in response to a call for increased regulation of the accounting profession following several major business failures.

In 1987, when the AICPA implemented a peer review requirement for all CPA firms in public practice, the PCPS program was incorporated into the Peer Review Program (PRP). Although the PCPS' main focus has changed to advocacy for small and medium-sized CPA firms, the 6,000 PCPS members have retained the "transparency" standard and continue to offer public access to members' most recent peer review reports, any letters of comment, any letters of response, and a description of any required follow-up action. The AICPA's PRP results, however, are generally considered confidential and are not public information nor provided to government regulators. According to the AICPA, the purpose of peer review is to "rigorously" look at a firm's system of quality control for its accounting and auditing practice to determine "where there is more than a remote possibility that the firm would not conform to professional standards." Therefore, reviewers

examine a representative sample of the firm's attest practice as part of the peer review process. Members performing attest functions are required to undergo and pay for a peer review every three years to maintain membership. Although the intent of peer review is "educational," refusal to undergo a peer review, consecutive adverse peer review reports, or repeated failure to correct significant deficiencies identified in a peer review report are grounds for expulsion from the AICPA. Individuals who wish to conduct peer reviews must participate in a peer review training course and submit an application and resume for the organization's approval. Once qualified, individual reviewers and, at times, teams of reviewers perform "peer" reviews of firms of like size and function as their own firms.

Currently, there are two peer review programs that follow the standards of the AICPA. The first is the AICPA's SECPS, which monitors 1,300 member firms that perform public company audits or wish to perform such audits.<sup>2</sup> SECPS firm membership requires a peer review every three years. All SECPS peer reviews are posted in a public file on the AICPA's Web site, which contains the firm's most recent peer review report, a letter of comments (if issued by the reviewer), the firm's response to the letter, and a description of any follow-up action deemed necessary.

The second program is the AICPA's PRP, which reviews 30,000 firms that do not perform public company audits, including engagements covered by the Government Auditing Standards (Yellow Book). Approximately 18,000 of the firms perform only review or compilation engagements and do not undergo a "system review."<sup>3</sup> The PRP also monitors system reviews of approximately 12,000 attest firms. System reviews evaluate the adequacy of the firm's system of quality control, assess compliance with professional standards, and recommend action to correct deficiencies and improve the firm's accounting and auditing practice.

## 2. WEAKNESSES OF TRADITIONAL PEER REVIEW.

Through its research and discussion of national events, the PRTF identified several significant weaknesses with the AICPA's traditional peer review program. First, the scope of peer review is quite limited. Certain types of engagements are "off-limits" for peer review scrutiny, including engagements that are the subject of litigation or government agency investigation. This loophole led one post-Enron pundit to comment that "it's as if a college student's grade point average were determined only after excluding all the classes in which he'd done poorly."<sup>4</sup> Additionally, reviewers are only able to review the audit documentation retained by the auditor, and — under AICPA standards — such documentation may not be detailed enough to adequately apprise the reviewer of underlying problems. In a September 24, 2002, letter to the AICPA (please see Appendix V), CBA expressed other concerns about the AICPA's peer review program relating to the frequency of peer review (which is inadequate for firms that have received modified or adverse reports) and the lack of transparency of peer review reporting.

Finally, and most fundamentally, peer review is exactly as it sounds — at its essence, it is peers reviewing peers, which raises strong conflict-of-interest concerns. The AICPA trains CPAs in

<sup>2</sup> This program is scheduled to be replaced in 2004 by the PCAOB's inspection program.

<sup>3</sup> A system review is the highest level of peer review a firm may undergo and requires the reviewer to express an opinion (for the year under review) regarding whether the firm's system of quality control for its accounting and auditing services meets AICPA's quality control standards and whether there is reasonable assurance that the firm is following its quality control policies and procedures and, thereby, complying with professional standards.

<sup>4</sup> Noam Scheiber, *Peer Revue: How Arthur Andersen Got Away With It*, NEW REPUBLIC (Jan. 28, 2002).

various states (usually associated with a state professional association consisting of and representing CPAs) to administer its peer review program. None of these individuals are affiliated with any regulator, and none have any duty to report adverse results to any regulator; none of these individuals are independent from the accounting profession. In its September 2002 letter to the AICPA, the CBA suggested that peer review programs be administered through state boards of accountancy instead of through private CPA associations.

Both before and after Enron, the SEC Chairs under two different administrations called for fundamental changes in the traditional peer review process. In early 2002, then-SEC Chair Harvey Pitt (as had former SEC Chair Arthur Levitt and former SEC Chief Accountant Lynn Turner) called for a “major overhaul” in the traditional peer review system. Mr. Pitt called for replacement of traditional peer review with “more frequent monitoring of audit quality and competence” performed by “permanent quality control staff” of a new accounting regulatory body dominated by non-CPAs. According to Mr. Pitt, such staff should be “knowledgeable people unaffiliated with any accounting firm,” and “deployed and overseen by the new publicly dominated body and its staff.”

### 3. FEDERAL LEGISLATION.

Enacted on July 30, 2002, the Sarbanes-Oxley Act established the PCAOB to oversee accounting firms that audit publicly traded companies. The PCAOB is under the purview of the SEC and will replace the AICPA's SECPS peer review program with its own program of regular inspections. PCAOB staff will register all public accounting firms auditing public companies. CPA firms that audit 100 or more issuers of exchange traded securities (public companies) will be inspected by the PCAOB every year, and CPA firms that audit less than 100 issuers will be inspected every three years. The PCAOB has authority to set and enforce standards with disciplinary actions and sanctions and is currently developing its program funding and hiring staff. The PCAOB does not expect to be fully operational to conduct a full range of inspections until 2004 when the PCAOB will replace the SECPS. Consequently, sufficient information to determine the effectiveness of the PCAOB's inspection program is unlikely to be available until late 2004 or 2005.

### 4. STATE LEGISLATION.

In order to address the crisis in investor confidence, the California Legislature enacted the following accounting reform measures in 2002:

- AB 270 (Chapter 231, Statutes of 2002) increases the number of Board members and converts the Board's composition to a public member majority. The bill enhances the Board's self-reporting requirements and requires licensees to report to the Board restatements, civil action settlements or arbitration awards over \$30,000, any investigations initiated by the SEC or the PCAOB, and any civil judgments against the licensee in cases alleging professional practice (dishonesty, fraud, negligence, breach of fiduciary responsibility, embezzlements, theft, or other professional misconduct). Further, it requires insurers and court clerks to report civil judgments and settlements and criminal convictions of CBA licensees to the Board. In addition, repeated negligent acts by licensees, in the same or in different engagements, is grounds for discipline by the Board.
- AB 2873 (Chapter 230, Statutes of 2002) establishes new audit documentation standards and requires documentation to be sufficiently complete that a knowledgeable reviewer with



no prior connection to the audit could review the documentation and understand the audit procedures that were performed.

AB 2873 defines audit documentation as a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached. AB 2873 also adopts the "rebuttable presumption" that if an audit procedure is not documented, it can be presumed that it was not performed. The burden of proof then shifts to the licensee and can be overcome by a preponderance of evidence.

- AB 2970 (Chapter 232, Statutes of 2002) restricts the employment of the auditor of a public company by the audit client for 12 months following the issuance of a financial statement report if certain conditions are met.
- SB 1955 (Chapter 1150, Statutes of 2002) prohibits CBA licensees from providing services for a commission to the officers and directors of publicly-traded companies and other large for-profit audit clients and to the officers and directors of client-sponsored retirement plans.

#### 5. AICPA'S PROPOSED PEER REVIEW CHANGES.

On May 30, 2003, the AICPA's Peer Review Board (PRB) issued an exposure draft of proposed revisions to the AICPA *Standards for Performing and Reporting on Peer Reviews*, pertaining to accounting firms that audit nonpublic entities. The PRB is accepting comments from regulatory agencies, members, and the public, which are due by August 8, 2003. The PRB does not anticipate adopting a final draft until October 2003, effective for peer reviews commencing on or after January 1, 2005.

The proposed changes would add new provisions to the standards requiring that:

- Peer reviewers consider two additional factors when assessing the peer review risk at the office level: (1) the extent of non-audit services provided by the auditor to the audit client, and (2) significant clients' fees to a practice office(s) and a partner(s).
- Peer reviewers consider the risk factor that the peer review may be unable to detect a firm's lack of compliance with its system of quality control and/or deficiencies in the firm's demonstrated competencies to perform accounting and auditing engagements.
- The firm under review notifies the peer reviewer of any investigation by a state, federal, or other regulatory body.

As a private professional organization, the AICPA is bound by its membership bylaws, and changes to those bylaws require a two-thirds membership vote. As a result, proposed changes that are controversial may be defeated, or never formally proposed. Certain proposed changes to the peer review standards that were discussed and supported at the PRB's January 2003 meeting were not included in the May 2003 exposure draft. For example, the exposure draft did not contain a requirement that peer review reports for system reviews be posted in a public file. In addition, although the standards were revised to require a firm to specify its license status in the representation letter to the reviewer, the firm is not required to provide verification of licensure.

## CONCLUSIONS.

In evaluating a mandatory peer review program, the PRTF confronted the following issues that require significant additional information not yet available:

- To avoid duplication of the PCAOB's inspections of firms that audit public companies, the PRTF decided to focus its peer review study on firms providing audit or review services to clients that are nonpublic companies. In order to reach this conclusion and consider the adoption of a similar inspection requirement in California for firms that audit nonpublic companies, the PRTF requires evidence that the PCAOB is efficiently and effectively meeting its inspection mandate under the Sarbanes-Oxley Act. However, the PCAOB is still in its formative stages and does not expect to be fully operational and conducting a full range of inspections until sometime in 2004. Although the PCAOB is expected to share its inspection program information with state regulatory agencies, sufficient information to determine its effectiveness may not be available until 2005 or later.
- To determine the need for a mandatory peer review program for auditors of nonpublic companies, the PRTF has to consider the level of risk posed to consumers by firms performing attest services for clients that are not publicly traded companies. The PRTF also must determine if the new state statutory and regulatory changes ultimately provide CBA with adequate tools to identify and mitigate deficiencies without a mandatory peer review program.
- To evaluate the AICPA's peer review program, the PRTF will also study the recently issued proposed revisions to the AICPA's current peer review standards. Although an exposure draft was issued at the end of May, a final document will not be available until after the AICPA's PRB meets in October 2003. Although the Board and members of the PRTF will provide formal comments to the exposure draft, a final determination on the standards' changes cannot be made until the standards have been formally adopted.

### **Recommendation:**

Once the comprehensive information described above becomes available, the PRTF plans to continue its evaluation of a mandatory peer review program in California. There is a possibility that the information will not be available in 2004. In that event, it will not be possible for the PRTF to reach an informed decision regarding mandatory peer review in that year. The Board recommends a new due date of September 1, 2005, to report its peer review findings. A 2005 report date would necessitate an amended peer review implementation date of July 1, 2008, if mandatory peer review or an alternative inspection program were adopted. The implementation of any new program would require additional funding and personnel augmentation.

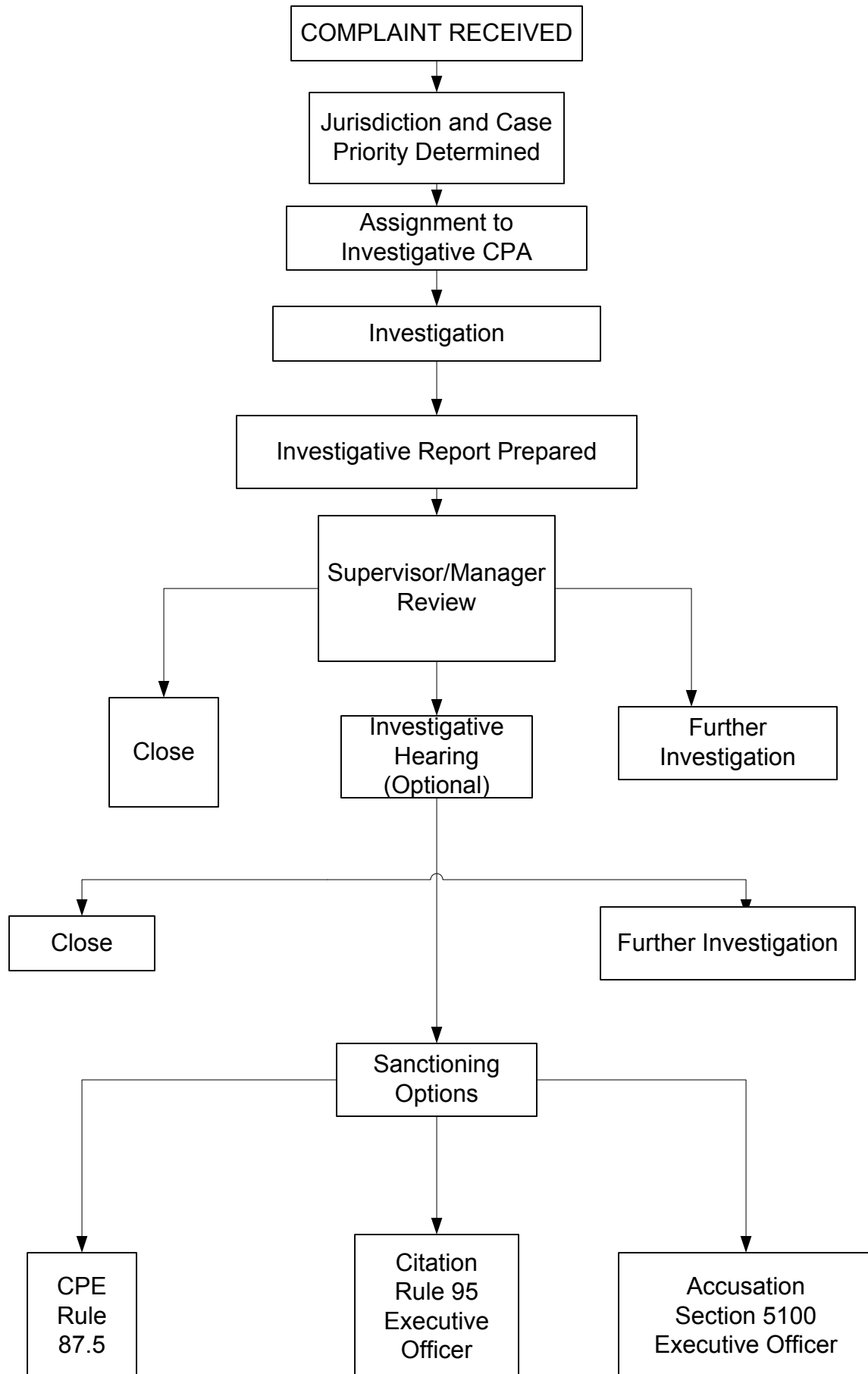


## APPENDICES TO 2003 *SUNSET REVIEW REPORT*

Appendix I	Enforcement Process Flow Charts
Appendix II	Complex Case Overview
Appendix III	Chronology of Efforts to Maintain and Augment Staffing
Appendix IV	Comparison of Licensure Pathway Requirements
Appendix V	September 24, 2002, Comment Letter to the AICPA

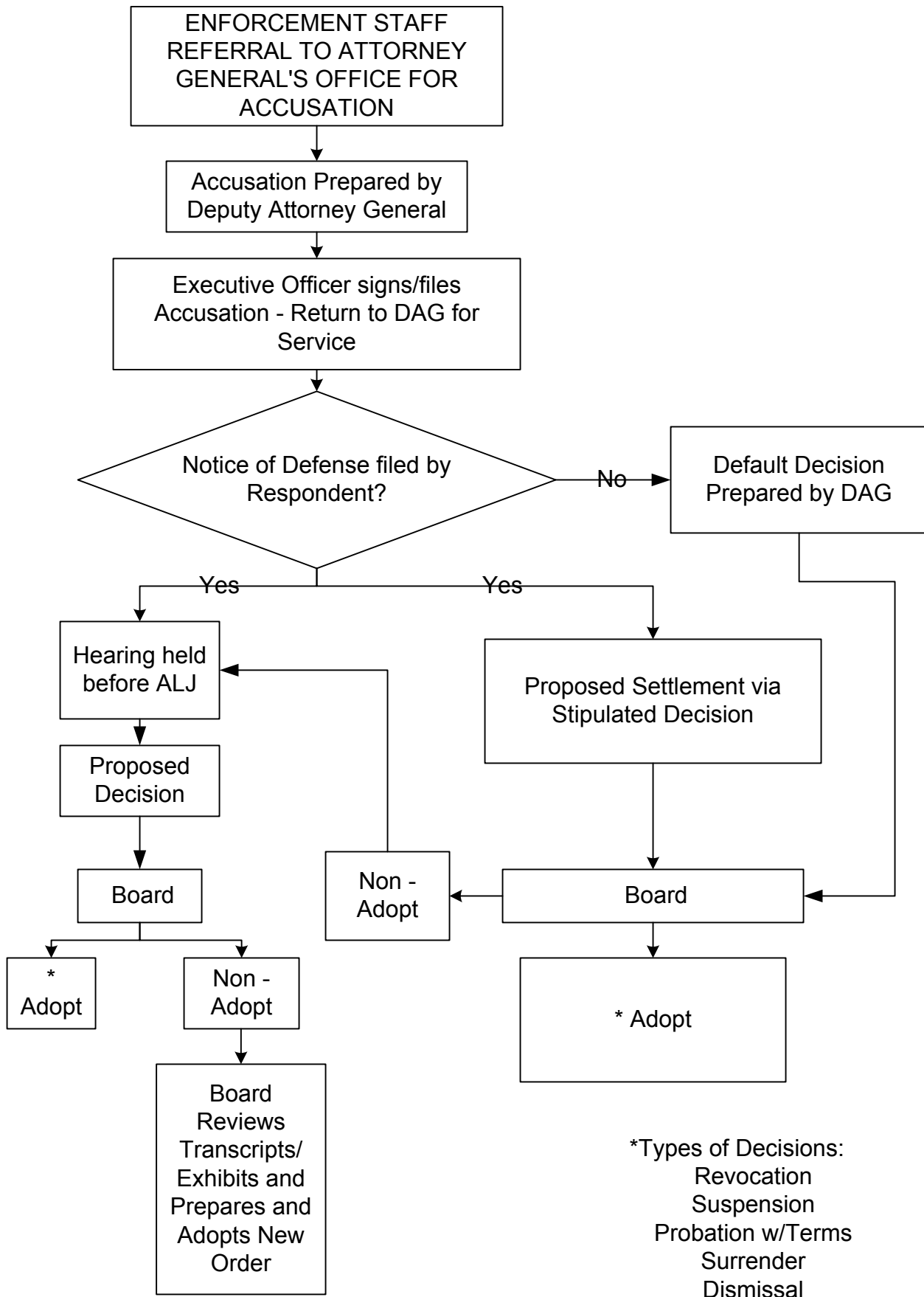
**CALIFORNIA BOARD OF ACCOUNTANCY  
ENFORCEMENT PROGRAM  
INVESTIGATIVE PROCESS**

**Appendix I (a)**



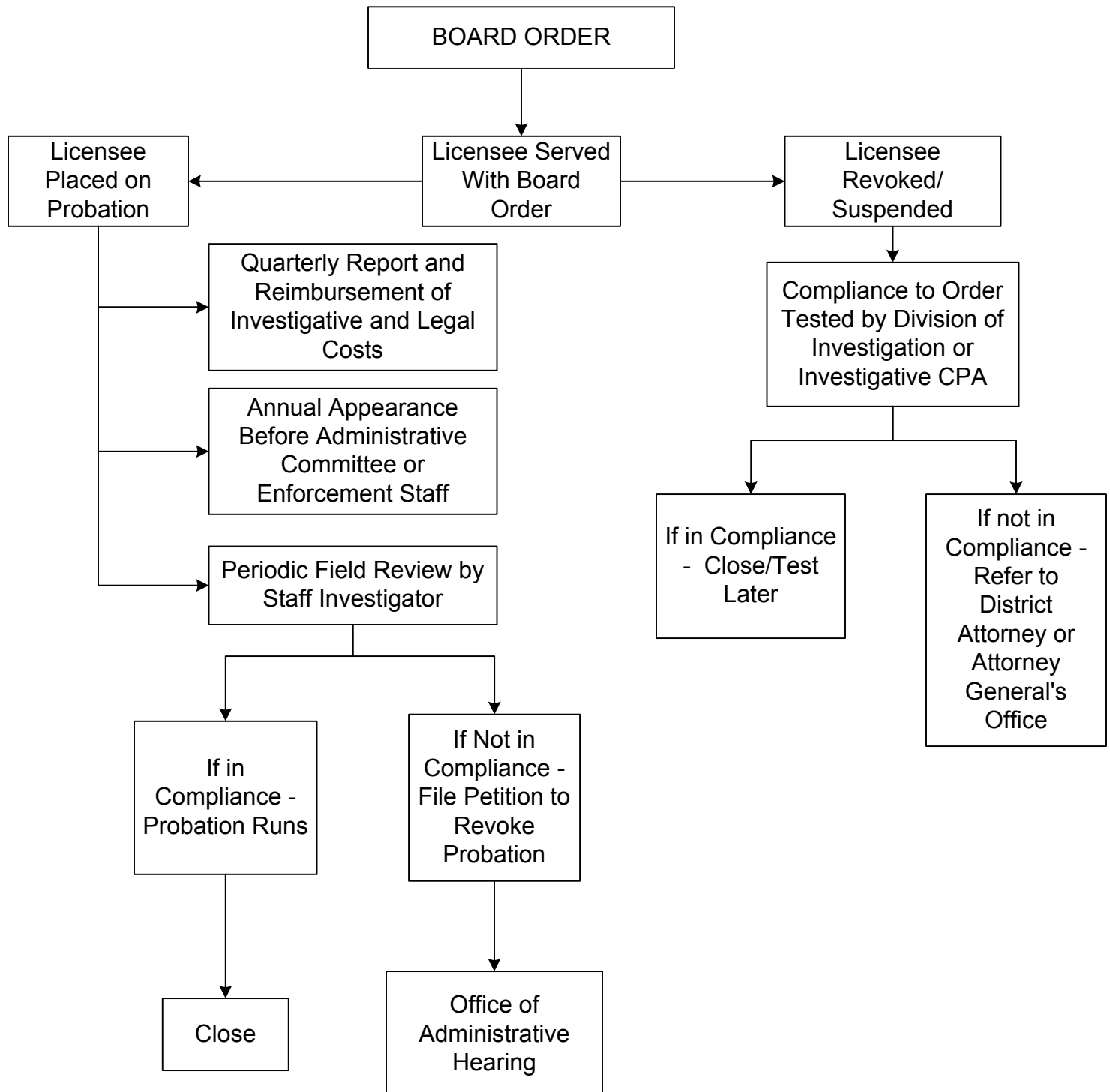
**CALIFORNIA BOARD OF ACCOUNTANCY  
ENFORCEMENT DIVISION  
CASE PROSECUTION\***  
In accordance with Government Code  
Section 11500

Appendix I (b)



**CALIFORNIA BOARD OF ACCOUNTANCY  
ENFORCEMENT DIVISION  
IMPLEMENTATION AND MONITORING  
THE DISCIPLINARY ORDER**

**Appendix I (c)**



## COMPLEX CASE OVERVIEW

## Appendix II

	<b>DURATION</b> (Some overlap occurs during various phases)	<b>COSTS</b>	<b>RESOURCES REQUIRED</b>	<b>DOCUMENTS</b>	<b>COMMENTS</b>
<b>INVESTIGATION</b>  (The initial investigation was opened in 12/94. Additional cases were opened and added to the investigation in 12/97.)	Four years to conduct the investigations, review 1000's of pages of transcripts and other evidence, conduct Administrative Hearings, interview a number of parties and witnesses, and prepare Accusation (see box below).	\$916,000	<ul style="list-style-type: none"> <li>▪ Executive Officer.<sup>1</sup></li> <li>▪ Chief of Enforcement.<sup>1</sup></li> <li>▪ Investigative CPA assigned <u>full time</u>.</li> <li>▪ Deputy Attorneys General.</li> <li>▪ Outside legal counsel.</li> <li>▪ Investigative Consultants and Expert Witnesses.</li> </ul>	Investigative file contains in excess of 60 archive boxes of material (pleadings, subpoenas, inquiries, correspondence and exhibits) that were located, subpoenaed and analyzed during the investigative phase. An electronic litigation support system was set up to collect, image, copy and distribute all documents related to the case.	The contracting process to secure outside resources during a complex matter is a major challenge. For example, to maintain the services of outside legal counsel in this case, the Board was required to amend the contract five times in order to obtain additional time and dollars. These challenges are ongoing during every phase of prosecuting a complex matter.
<b>ACCUSATION</b>  (As a result of the investigation, an accusation was filed in 12/98.)	One year to review investigation results, prepare, refine and discuss with Executive Officer/Complainant before filing the accusation. Various settlement modalities were explored including the use of the Board's Mediation Guidelines.	\$200,000	<ul style="list-style-type: none"> <li>▪ Investigative CPA assigned <u>full time</u>.</li> <li>▪ Deputy Attorneys General.</li> <li>▪ Outside legal counsel.</li> <li>▪ Investigative Consultants and Expert Witnesses.</li> <li>▪ AGO Litigation Support Service.</li> </ul>	Preparation of the accusation requires extensive time reviewing and evaluating the documents and other evidence from the investigation to determine the violations to be charged.	Although the costs of any case continue beyond the investigative stage, Board statutes only allow the recovery of said costs up to the start of the hearing.

<sup>1</sup> Both the Executive Officer and the Chief of Enforcement are involved at all phases of a Major Case.

## COMPLEX CASE OVERVIEW

	<b>DURATION</b> (Some overlap occurs during various phases)	<b>COSTS</b>	<b>RESOURCES REQUIRED</b>	<b>DOCUMENTS</b>	<b>COMMENTS</b>
<b>CIVIL ACTION [FILED BY RESPONDENTS]</b>  (Filed by Respondents shortly after the filing of the Accusation and the commencement of the pre-hearing/hearing phase, necessitating redirection of resources.)	One year to respond and litigate action for Injunctive and Declaratory Relief and Writ. Also defended DCA, and individuals sued under 1983 action. Included favorable decision by the Court of Appeal.	\$35,000	<ul style="list-style-type: none"> <li>Deputy Attorneys General.</li> </ul>	Lengthy and complex documents are prepared and filed in response to a civil action filing.	<ul style="list-style-type: none"> <li>The filing of a civil action is a possibility in any case in an effort to prevent the disciplinary action from taking place.</li> <li>Responding to these actions diverts staff and resources from Enforcement activities.</li> <li>Department and Board personnel were sued individually for monetary damages in this civil action.</li> </ul>
<b>PUBLIC RECORDS REQUEST [FILED BY RESPONDENTS]</b>  (Filed by Respondents shortly after the filing of the Accusation and the commencement of the pre-hearing/hearing phase, necessitating redirection of resources.)	One year involving two extensive public record requests.	\$60,000	<ul style="list-style-type: none"> <li>Investigative CPA.</li> <li>Various Board/Division Staff.</li> <li>DCA Staff Counsel.</li> <li>Outside legal counsel.</li> </ul>	<ul style="list-style-type: none"> <li>Respondent's two large public record requests required in excess of 300 hours of staff time and 150 hours of legal counsel time to research, locate, respond, and copy.</li> <li>16 archive boxes of material were gathered.</li> <li>Approximately 6,500 copies were prepared.</li> </ul>	When a staff member is taken offline to address a large public record request, the regular duties of that person are greatly impacted.

## COMPLEX CASE OVERVIEW

	<b>DURATION</b> (Some overlap occurs during various phases)	<b>COSTS</b>	<b>RESOURCES REQUIRED</b>	<b>DOCUMENTS</b>	<b>COMMENTS</b>
<b>DISCIPLINARY CASE/ ADMINISTRATIVE HEARING</b>  (The hearing commenced on March 15, 2000.)	Four and one-half years between filing disciplinary case and the Board's adoption of the decision. Extensive pre hearing motions. One hundred and one days of testimony. Hearing length extended by continuances, protracted, discovery and extensive brief filings.	\$6,800,000	<ul style="list-style-type: none"> <li>Investigative CPA assigned <u>full time</u>.</li> <li>Deputy Attorneys General.</li> <li>Outside legal counsel.</li> <li>Investigative Consultants and Expert Witnesses.</li> <li>Office of Administrative Hearings.</li> <li>Training in and utilization of AGO and outside litigation support service.</li> </ul>	<ul style="list-style-type: none"> <li>43 archive boxes of trial exhibits (in excess of 5,000 documents) were utilized during the Administrative Hearing.</li> <li>Both hard copy and electronic format were maintained.</li> <li>Pages of transcripts from the hearing amounted to 8-archive boxes of ASCII disks.</li> </ul>	(None applicable.)
<b>WRIT (CCP 1094.5) [FILED BY RESPONDENTS]</b>  (Writ filed in response to Board's Decision adopted July 25, 2002.)	One year and continuing.	\$170,000 (ongoing)	<ul style="list-style-type: none"> <li>Deputy Attorneys General.</li> <li>Litigation Support Service.</li> </ul>	Hearings, appeals, and writs on any contested case are handled through the Board's legal counsel. When a writ is filed, the administrative record must be prepared and lodged with the court.	The trial on the writ was heard on July 10, 2003. The administrative record consisted of approximately 50 boxes of documents. The briefs filed by the parties were approximately 100 pages.
<b>APPEAL [FILED BY RESPONDENTS]</b>  (Interlocutory appeals filed re: rulings of judge deciding 1094.5 writ.)	One year and continuing.	\$18,000 (ongoing)	<ul style="list-style-type: none"> <li>Deputy Attorneys General.</li> </ul>	<ul style="list-style-type: none"> <li>Appeals of civil actions require briefs and arguments to be prepared and presented at the Court of Appeal.</li> <li>Appeal related to Writ.</li> </ul>	Petitioners filed two petitions with the Court of Appeal and one Petition with the Supreme Court seeking to overturn adverse rulings made by the trial judge while the petition was pending.



## COMPLEX CASE OVERVIEW

	<b>DURATION</b> (Some overlap occurs during various phases)	<b>COSTS</b>	<b>RESOURCES REQUIRED</b>	<b>DOCUMENTS</b>	<b>COMMENTS</b>
<b>JUDGEMENT DENYING PEREMPTORY WRIT OF MANDAMUS (FILED BY COURT)</b>	Filed on July 10, 2003	Billings not yet available	▪ Deputy Attorneys General.	▪ The record of the administrative proceedings were received into evidence and examined by the court.	Following the trial, the amended petition for a peremptory writ of mandamus was denied. Petitioners did not file objections and the judge entered our judgment without any significant modifications on August 4, 2003. Petitioners will have 60 days to file their Notice of Appeal from the Notice of Entry of Judgment.
<b>MEMORANDUM OF COSTS (FILED BY THE BOARD)</b>	Filed on August 14, 2003	Billings not yet available	▪ Deputy Attorneys General.	▪ A copy of the Reporter's Transcript of Proceedings for Tuesday July 10, 2003, was made available.	As part of the judgment, the court awarded the Board costs. The types of costs recoverable are limited, but include preparation of the administrative record.
<b>NOTICE OF INTENTION TO MOVE FOR NEW TRIAL (FILED BY RESPONDENTS)</b>	Filed on August 19, 2003	Billings not yet available	▪ Deputy Attorneys General.	▪ Supporting papers to be filed by Petitioner's before Friday, August 29, 2003.	The court's ability to order a new trial is limited by statute. The bases Petitioner's identified that they intend to move for a new trial are 1. The Decision is against law 2. Newly discovered evidence. The court will be required to act on the motion within 60 days.

**CHRONOLOGY OF CALIFORNIA BOARD OF ACCOUNTANCY'S EFFORTS TO MAINTAIN AND AUGMENT STAFFING**

<b>Date</b>	<b><u>ADMINISTRATION PROGRAM</u></b>		<b><u>LICENSING PROGRAM</u></b>		<b><u>ENFORCEMENT PROGRAM</u></b>	
	<b>Action</b>	<b>Result of Action</b>	<b>Action</b>	<b>Result of Action</b>	<b>Action</b>	<b>Result of Action</b>
10/23/2001	<b>Hiring Freeze declared per Executive Order D-48-01. At the time hiring freeze initiated, the California Board of Accountancy had 5 vacant positions.</b>					
11/30/2001	Freeze Exemption Request (FER) submitted on 11/30/01 to fill new permanent position, created by Department of Finance (DOF) approving conversion of 1 PY of Temp Help to a permanent OA, position 615-210-1379-001.	FER approved by DOF on 3/15/02. Position filled with new employee effective 5/6/02.				
12/31/2001			FER submitted on 12/31/01, due to employee leaving Board and vacating Initial Licensing OT position 615-320-1139-007.	FER approved by DOF on 3/25/02. Position temporarily filled with internal movement of staff, and eventually filled with new employee hire on 5/15/02.		
12/31/2001			FER submitted on 12/31/02, due to OA vacating Exam position 615-330-1379-001.	FER approved by DOF on 3/17/02. Position filled with new employee hire on 4/22/02.		
12/31/2001			FER submitted on 12/31/01, due to employee leaving Board and vacating Initial Licensing OT position 615-320-1139-011.	FER approved by DOF on 3/25/02. Position downgraded to OA for recruitment purposes, and filled with new employee hire on 4/29/02.		
12/31/2001			FER submitted on 12/31/01 due to employee leaving the Board and vacating Initial Licensing OT position number 615-320-1139-004.	FER approved by DOF on 3/25/02. Position downgraded to OA for recruitment purposes, and filled with new employee hire on 5/6/02.		
12/31/2001			FER submitted on 12/31/01, due to employee leaving the Board and vacating Exam OT position 615-330-1139-016.	FER approved by DOF on 3/17/02. Position filled with new employee hire on 4/22/02.		

**CHRONOLOGY OF CALIFORNIA BOARD OF ACCOUNTANCY'S EFFORTS TO MAINTAIN AND AUGMENT STAFFING**

Date	<u>ADMINISTRATION PROGRAM</u>		<u>LICENSING PROGRAM</u>		<u>ENFORCEMENT PROGRAM</u>	
	Action	Result of Action	Action	Result of Action	Action	Result of Action
12/31/2001			FER submitted on 12/31/01, due to OT vacating Renewal position 615-340-1139-003.	FER not approved by DOF. Position filled with internal staff from Initial Licensing unit on 4/1/02. <b>Vacant Initial Licensing position was abolished on 7/1/02.</b>		
12/31/2001					FER submitted on 12/31/01 due to employee leaving the Board and vacating ICPA position number 615-410-6612-006.	FER approved by DOF on 3/13/02 and filled with new employee hire on 5/31/02.
5/1/2002	FER submitted on 5/1/02, due to employee leaving Board and vacating OT position 615-210-1139-020.	FER was not approved by DOF. Position was downgraded to an OA in May 2002 and internal staff was moved into this position, then promoted in place to OT effective 6/1/02. New position number is 615-210-1139-003.				
5/28/2002					FER submitted on 5/28/02, due to employee passing away and leaving ICPA position 615-410-6612-003 vacant.	<b>FER was not approved by DOF and position was abolished on 7/1/02.</b>
6/3/2002			BCP submitted to request one SSA and one OA position to establish the Peer Review Program.	The Board withdrew this BCP in light of BL 02-20, which stated BCPs to fund new initiatives or program expansions will not be reviewed, and will be returned.	BCP submitted to request one Investigative CPA for accounting and auditing standards reform.	<b>DOF returned BCP without consideration on 10/10/02.</b>
6/7/2002	FER submitted on 6/7/02, due to employee being promoted internally and vacating OA position 615-210-1379-001.	<b>FER was not approved by DOF and position was abolished on 7/1/02.</b>				

# CHRONOLOGY OF CALIFORNIA BOARD OF ACCOUNTANCY'S EFFORTS TO MAINTAIN AND AUGMENT STAFFING

Date	<u>ADMINISTRATION PROGRAM</u>		<u>LICENSING PROGRAM</u>		<u>ENFORCEMENT PROGRAM</u>	
	Action	Result of Action	Action	Result of Action	Action	Result of Action
7/18/2002					FER submitted on 7/18/02, due to employee leaving State service and vacating OT position 615-410-1139-006.	Internal staff transfer into position from 11/25/02 to 1/31/03 and position moved to Initial Licensing on 1/31/03. Movement of position nullified FER. (See 2/28/03 below)
8/5/2002					Request for Classification Study/Salary Realignment for Investigative CPA Classification submitted to DCA. DCA held request due to hiring freeze and submitted the package to DPA on 7/14/03.	<b>DPA rejected proposal on 7/22/03.</b>
10/7/2002	FER submitted on 10/7/02, due to employee leaving the Board and vacating OT position 615-210-1379-009.	FER was not approved by DOF, but position was filled by employee returning to the Board under mandatory reinstatement, effective 11/25/02.				
2/28/2003			New FER submitted on 2/28/03 following movement of prior Enforcement position to Initial Licensing. (See 7/18/02 above)	<b>FER not approved by DOF and position was abolished on 6/30/03.</b>		
2/28/2003			FER submitted on 2/28/03 due to employee leaving State service and vacating Initial Licensing OT position 615-320-1379-001.	<b>FER was not approved by DOF and position was abolished on 6/30/03.</b>		
2/28/2003			FER submitted on 2/28/03, due to employee leaving the Board and vacating Exam OT position 615-330-1139-021.	FER was not approved by DOF. Position filled with internal staff from the Renewal Unit on 5/1/03. <b>Vacant Renewal position was abolished on 6/30/03.</b>		

CHRONOLOGY OF CALIFORNIA BOARD OF ACCOUNTANCY’S EFFORTS TO MAINTAIN AND AUGMENT STAFFING

Date	<u>ADMINISTRATION</u> PROGRAM		<u>LICENSING</u> PROGRAM		<u>ENFORCEMENT</u> PROGRAM	
	Action	Result of Action	Action	Result of Action	Action	Result of Action
5/9/2003	FER submitted on 5/9/03, due to employee leaving Board and vacating OA position 615-210-1379-002.	<b>FER was not approved by DOF, and position was abolished on 6/30/03.</b>				
5/21/2003					Identified need for three Investigative CPA positions at a Special Issues Budget Hearing.  After conference committee, the three positions were added to the budget.	<b>Notified on 7/28/03 that the Senate deleted the three positions from the budget and appropriated \$270,000, identified as the cost for these positions, as a loan to the General Fund.</b>
7/2/2003	BCP submitted to restore one Office Assistant position.	<b>On 8/5/03, DOF determined that BCP did not warrant further consideration.</b>	BCP submitted to restore one Office Technician position.	<b>On 8/5/03, DOF determined that BCP did not warrant further consideration.</b>	BCP submitted to restore one Investigative CPA position.	<b>On 8/5/03, DOF determined that BCP did not warrant further consideration.</b>
8/27/2003					BCP submitted to DCA at Agency’s request to restore one Investigative CPA position and acquire an additional three Investigative CPA positions for FY 04/05.	Pending.

Summary of Authorized Positions  
Fiscal Year 2001-02 to Present

Category	A		B	C	D	E
	FY 2001/02 Authorized Positions	FY 2001/02 Temporary Help to Permanent Position	FY 2002/03 Section 31.60 Budget Reduction	FY 2003/04 Authorized Positions	FY 2003/04 12% Personal Services Reduction	Anticipated FY 2003/04 Authorized Positions
Permanent Positions	63.0	1.0	-3.0	61.0	-4.75	<b>56.3</b>
Exam Proctors	15.2	-	-	15.2	-13.2	<b>2.0</b>
Temporary Help (TH)	6.1	-1.0	-	5.1	-	<b>5.1</b>
<b>TOTAL</b>	<b>84.3</b>	<b>0.0</b>	<b>-3.0</b>	<b>81.3</b>	<b>-17.9</b>	<b>63.4</b>

Footnotes:

- A: Dept. of Finance, per Board’s request, converted 1.0 PY Temporary Help to a permanent Office Assistant position for the Reception Unit.
- B: Due to the hiring freeze and statewide budget constraints, the Board **lost 3.0 permanent positions (ICPA, OT & OA)** and **1 Student Assistant position** (funded by temp help) in the Licensing Unit.
- D: Proposed 12% Reduction to Personal Services per Budget Letter 03-21 will potentially eliminate **4.75 vacant positions**, and reduce Exam Proctor authority by 13.2 positions.

### Comparison of Pathway Requirements

Applicants have several options from which to choose when applying for the CPA license in California.

Each pathway has its own educational requirement, examination passage standard (conditional credit), and licensure requirement.

The following is a comparison of the pathway requirements:

	<b>Pathway 0</b>	<b>Pathway 1</b>	<b>Pathway 2</b>
<b>Education Requirements for Exam</b>	Baccalaureate degree <b>or</b> 120 semester units — no degree <b>or</b> CLEP	Baccalaureate Degree	Baccalaureate Degree
<b>Core Course Requirements</b>	<ul style="list-style-type: none"> <li>▪ 10 semester units of accounting.</li> <li>▪ 35 semester units of business-related subjects.</li> </ul>	<ul style="list-style-type: none"> <li>▪ 24 semester units of accounting.</li> <li>▪ 24 semester units of business related subjects.</li> </ul>	<ul style="list-style-type: none"> <li>▪ 24 semester units of accounting.</li> <li>▪ 24 semester units of business-related subjects.</li> </ul>
<b>Examination Conditioning</b>	<b>Current</b>	<b>Current</b>	<b>UAA</b>
<b>Licensure Requirements</b>	<ul style="list-style-type: none"> <li>▪ 24, 36 or 48 months of experience, which includes attest experience.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Two years general experience, which may include 500+ attest hours for those who want to sign attest reports.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Evidence of 150 semester hours of education <b>and</b></li> <li>▪ One-year general experience, which may include 500+ attest hours for those who want to sign attest reports.</li> </ul>

**CALIFORNIA BOARD OF ACCOUNTANCY**

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## Appendix V

September 24, 2002

Dean Beddow, Senior Technical Manager  
AICPA Peer Review Program  
201 Plaza Three  
Jersey City, NJ 07311-3881

Dear Mr. Beddow:

Newly-enacted California law mandates that the California Board of Accountancy examine the need for mandatory peer review in light of recent changes at the federal level and report the findings to the California Legislature in September 2003. In furtherance of this requirement and in order to prepare a detailed study, the Board has formed a task force which will be chaired by licensee Board member Charles Drott. When this study is completed, the Board will be in a better position to evaluate the strengths and weaknesses of the AICPA's current Program. However, the Board would like to provide the AICPA comments and suggested as provided below in response to the July 11, 2002, survey questions. Thank you for extending the comment deadline until September 24, 2002, so that this Board could discuss the matter at its September 20, 2002, meeting.

The California Board of Accountancy understands that the Program on which we are commenting relates only to firms auditing non-public entities since that is what the AICPA has requested in its July 11, 2002, cover letter. As a practical matter, however, certain observations and recommendations closely follow similar recommendations which have been made regarding auditors of public companies.

**Survey Question (1): Objectives of a System Peer Review**

The California Board of Accountancy suggests the following revisions to the objectives that were provided along with the survey (suggested changes are underlined).

A system review is intended to provide the reviewer with a reasonable basis for expressing an opinion on whether, during the year under review:

- a. The reviewed firm's system of quality control for its accounting and auditing practice has been designed in accordance with quality control standards established by the AICPA and to ensure compliance with all applicable professional, ethical and regulatory requirements and standards.

- b. The reviewed firm's quality control policies and procedures were being complied with to provide the firm with reasonable assurance of conforming with all applicable professional, ethical and regulatory requirements and standards.
- c. The reviewed firm's quality control system was designed and was being complied with to prevent the issuance by the reviewed firm of inappropriate or misleading reports on financial statements.

### **Survey Question 2: Frequency of Peer Review**

The current policy of performing a peer review every three years may be appropriate for firms that receive an unmodified report from their last peer review. However, consideration should be given to exploring the need to have firms that receive either modified or adverse reports to have a peer review more frequently until significant improvement is seen in their professional work. For example, if this were the case, firms receiving adverse reports would have a peer review annually and firms receiving a modified report would have a peer review at least every two years (or possibly annually) until such time as they receive an unmodified report. The AICPA should also carefully consider what other events or circumstances will trigger non-routine peer reviews (such as publicized audit failures, complaints received by state boards of accountancy, investigations by regulatory agencies, etc.). Frequency of peer reviews should not be established arbitrarily but, instead, be need to be based on the results of prior reviews or by other significant events or circumstances, as described above. Such policies should increase overall professional services quality.

### **Survey Question 3: Scope of System Reviews:**

The current system of peer review has certain critical scope limitations that may need to be eliminated in order for the peer review process to become more independent and thorough, and, in turn, to achieve improved public confidence. Currently, the peer review standards state that a reviewed firm may have legitimate reasons for not permitting the working papers for certain engagements to be reviewed, including those that may be the subject of litigation or governmental investigation or the firm may have been advised by a client that it will not permit the review of the work papers for the audit of its financial statements. Further, current peer review standards do not require the peer reviewer to review portions of audits performed by other offices, correspondents, or affiliate firms.

These are serious limitations on the scope of peer reviews that may need to be eliminated to the extent legally permissible so that all work papers and files are available for inspection by the peer review team. A continued program that



allows these scope limitations may be viewed to lack credibility and viability as a safeguard of audit quality and may further be viewed as a self-perpetuating, self-regulatory system that is part of the problem and not part of the solution.

#### **Survey Question 4: Transparency of Peer Review Reporting**

One of the more significant issues that is brought up is that the current peer review program lacks transparency. The results and details of peer reviews are not currently publicly reported, and, as a result, those that rely on independent audits do not have access to the results of the peer reviews of the professionals that perform such audits. This may be viewed as contrary to the spirit of the requirement in the AICPA's Peer Review Standards (PR 100.26) which states that "[f]irms have system reviews because of the public interest in the quality of the engagements covered under a system review, and the importance to the accounting profession of maintaining the quality of those services." (Emphasis added). Certain issues that may need to be considered are the possible reporting of the results of all peer reviews to state boards of accountancy and state boards' authority to further handle such results. There are many related issues and questions, which will arise, including the state boards' being enabled to take disciplinary and investigatory action and to monitor the progress of any remedial steps imposed on the appropriate parties. This could represent a major step forward in reducing the current self-regulatory stigma that the current program has developed over the years. The California Board will be studying these issues in the coming year.

#### **Survey Question 5: Other Aspects of Peer Review**

There are some additional thoughts for consideration, which the California Board also will look at in the following year:

- a. In order to further eliminate the self-regulatory stigma regarding the current peer review program, the AICPA should have its program administered through the nation's state boards of accountancy instead of private CPA societies which are professional associations and not independent public entities.
- b. One of the five elements of a firm's quality control policies and procedures applicable to a firm's accounting and auditing practice relates to "independence, integrity and objectivity." Despite the critical nature of this element of quality control and the publicized widespread abuses in this area of practice, there is little specific emphasis contained in the peer review standards for reviewing the area of independence, integrity and objectivity. PR 100.41 merely states that "[t]he review team should obtain a sufficient understanding of the reviewed firm's system of quality control with respect to each element to plan the review...." Moreover, in the

"Extent of Compliance Tests" section of the standards (PR 100.44), the only specific compliance testing suggested regarding that area is very general in nature. Because of the vital nature of this area and the huge ethical problems uncovered in recent years, the peer review program should greatly expand its requirements for reviewing this area and the peer review standards should be made more specific regarding compliance testing of the area.

- c. One of the key problems in any peer review is that the logic and thought processes supporting important audit judgments are frequently not documented in the audit work papers. Thus, there is no effective manner for the peer reviewer to evaluate the soundness of such audit judgments and their compliance with professional standards. At a minimum, such a deficiency in the audit documentation presents a significant scope limitation on the peer review of the audit firm's work if not otherwise resolved. The AICPA could emphasize the risks involved in a peer review when there is such a lack of audit documentation and give specific guidance in the peer review standards to expand peer review procedures to determine, if possible, whether or not the audit work was actually performed and, if so, whether the audit judgments were appropriate and complied with professional standards.
- d. The peer review standards and guidance currently emphasize the requirement for a firm to comply with professional standards. However, as referred to in the response to Question 1 herein, such standards and guidance could also stress the requirement to comply with ethical and regulatory requirements and standards. Such regulatory requirements would include those from state boards of accountancy and other non-SEC regulatory agencies that have a financial reporting impact relative to the audit being peer reviewed.

In closing, the California Board notes that all of the comments included herein are based solely on the AICPA's existing program as if it were going to continue. However, the recently disbanded Public Oversight Board ("POB") concluded that "peer review, as it has been conducted, should be discontinued in favor of a more thorough, independent, and transparent system." ("The Road to Reform," a White Paper from the Public Oversight Board, p. 23 [March 19, 2002]). The POB further recommended such change for both public and **non-public firms**.

Further, SEC Chairman Harvey Pitt, relative to public companies, recently stated that "[t]here should be a reform of the current peer review process that avoids firm-on-firm review. The new process should replace the current triennial firm-on-firm review with more frequent monitoring of audit quality and competence designed to produce better audits in the future. There should be a permanent Quality Control staff (at a new independent agency) composed of knowledgeable people unaffiliated with any

accounting firm. The staff should be deployed and overseen by the new publicly dominated body and its staff." (Harvey L. Pitt, Public Statement by SEC Chairman, Regulation of the Accounting Profession [January 17, 2002]).

In view of the vast public criticism of the existing peer review process, including those described above, the California Board of Accountancy recommends that the AICPA conduct a thorough and full scale review of its peer review program to determine what reforms need to be put into effect to address the concerns set forth above. As I mentioned, this Board will also be conducting a thorough study of the peer review system, a part of which will be an analysis of the issues set forth in this letter, and one of the more important issues will be whether the peer review program should be administered and controlled by state boards of accountancy and not by the AICPA or any state professional association.

Thank you for the opportunity to provide input into enhancing the AICPA Peer Review Program. Should you have any questions or need additional information regarding our comments, please contact the Executive Officer, Carol Sigmann, at (916) 263-3980.

Sincerely,

Navid Sharafatian  
Board President

c: Members, California Board of Accountancy